IT 99-0053-GIL 5/05/1999 ADDITION MODIFICATION – INTEREST -- APPORTIONMENT – FINANCIAL ORGANIZATIONS

General Information Letter: Portfolio interest income of a foreign corporation exempted from federal income taxation under IRC § 881 is not subject to add-back under IITA Section 201(b)(a)(A). Activities of an independent contractor on behalf of a financial organization do not constitute management of securities by financial organization for purposes of IITA Section 304(c)(1)(A).

May 5, 1999

Dear:

This is in response to your letter received December 21, 1998 in which you request a General Information Letter. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information we have enclosed a copy of 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department.

In your letter you stated:

> Pursuant to Illinois Administrative Code §1200.120, we hereby request a General Information Letter from the Illinois Department of Revenue (the "Department") regarding the Illinois income tax issues described below.
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> **BACKGROUND:**
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> We represent numerous corporations formed under the laws of various foreign countries (referred to herein as the "Foreign Corporation"). The Foreign Corporation may have U.S. and foreign shareholders. The Foreign Corporation's only activity consists of investing and trading in securities or commodities, futures contracts, currencies and interest rate swaps for its own account. The Foreign Corporation does not have any facilities or employees in Illinois. The Foreign Corporation would like to enter into an agreement (the "Agreement") with an unrelated Illinois corporation (the "Independent Contractor") for the management and administration of the Foreign Corporation in Illinois. The Independent Contractor would manage all investment activities of the Foreign Corporation. The Independent Contractor would also assume all administrative functions of the Foreign Corporation, including maintaining the Foreign Corporation's books and records, paying service providers, calculating the Foreign Corporation's net asset values, processing the purchase and redemption of shares and sending reports to shareholders.
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> The Foreign Corporation is treated as a "corporation" for federal incomes tax purposes. The only income of the Foreign Corporation is capital gain income from the trading of securities as described above, and interest income from obligations described in §881(c) (referred to as "portfolio interest") of the Internal Revenue Code of 1986, as amended (the "Code").

The Foreign Corporation has not been liable for federal incomes tax in prior years and will not become liable for federal income tax as a result of the execution of the Agreement, for the reasons described below.

Under the Code, a foreign corporation engaged in a "trade or business within the United States" is taxable at regular corporate income tax rates on its taxable income which is effectively connected with the conduct of a trade or business within the United States. In determining taxable income subject to regular corporation income tax rates, gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States. Under §864(b) of the Code, certain foreign corporations that trade in stocks or securities, or commodities, for their own account are not considered to be engaged in a "trade or business within the United States."

For taxable years beginning prior to January 1, 1998, a foreign corporation whose principal business is the trading of stock or securities for its own account, whether through its employees or through a United States broker or a similar agent, was not considered engaged in a trade or business within the United States so long as the principal office of the corporation was outside the United States and the corporation was not a dealer in stocks or securities. The regulations underlying this statutory requirement set forth in list of ten business functions (commonly referred to as the "ten commandments") that, if a substantial portion are performed outside the United States, would assure a foreign corporation that its principal office was not in the United States. Effective for taxable years beginning after December 31, 1997, in the case of foreign corporations that trade in stock or securities for their own account, the Taxpayer Relief Act of 1997 repealed the requirement that such foreign corporation's principal office be outside the United States to meet the exception from characterization as a "trade or business with the United States." Consequently, for taxable years beginning after December 31, 1997, foreign corporations that trade in stocks or securities for their own account no longer need to comply with the ten commandments and may have their principal office in the United States without being considered as engaged in a United States trade or business.

However, foreign corporations that are not engaged in a "trade or business within the United States" will still be subject to federal income tax at a rate of 30 percent if they have fixed or determinable annual or periodic income from sources within the United States. Such income generally excludes portfolio interest and capital gains.

Accordingly, for federal incomes tax purposes, the Foreign Corporation would be able to enter into the Agreement with the Independent Contractor for the management and administration of the Foreign Corporation in Illinois without causing the Foreign Corporation to be engaged in a "trade or business within the United States." Additionally, because all income of the Foreign Corporation is portfolio interest and capital gains, the Foreign Corporation would not be subject to the 30 percent federal income tax on fixed or determinable annual or periodic income, resulting in no federal income tax liability for the Foreign Corporation.

ISSUES

1. Whether the portfolio interest income of the Foreign Corporation would be an addition modification to federal taxable income under §203(b)(2)(A) of the Illinois Income Tax Act (the "IITA")?

2. Whether the Foreign Corporation would be classified as a "financial organization" within the meaning of §1501(a)(8) of the IITA?

3. Whether execution of the Agreement between the Foreign Corporation and the Independent Contractor for the performance by the Independent Contractor of the services described above would cause income of the Foreign Corporation to be apportioned to Illinois under the one-factor apportionment formula applicable to financial organizations?

4. Whether execution of the Agreement between the Foreign Corporation and the Independent Contractor for the performance by the Independent Contractor of the services described above would cause income of the Foreign Corporation to be apportioned to Illinois under the three-factor apportionment formula applicable to corporations?

ANALYSIS

ISSUE 1.

Illinois income tax law follows federal income tax law for purposes of determining the classification of an entity. Any entity treated as a corporation for federal income tax purposes will be treated as a corporation for Illinois income tax purposes. Under the IITA, corporations (including domestic out-of-state and non-domestic corporations with net income allocable to Illinois) are subject to Illinois corporate income tax of 4.8 percent and Illinois personal property tax replacement income tax of 2.5 percent on their net income for a taxable year.

Illinois has adopted federal income tax law as the starting point for computing Illinois net income. A corporation's Illinois net income for a taxable year is the portion of its base income for such year which is allocable to Illinois. A corporation's base income is determined by reference to its taxable income for federal income tax purposes under the Code, subject to certain addition and subtraction modifications.

Section 203(b)(2)(A) of the IITA provides that, in computing a corporation's Illinois base income, the corporation must add to its federal taxable income "[a]n amount equal to all amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the taxable year to the extent excluded from gross income in the computation of taxable income." As discussed above, portfolio interest income is excluded from the Foreign Corporation's federal taxable income. It is not clear from the statutory language whether portfolio interest income was intended by the Illinois Legislature to be added back to a corporation's federal taxable income in computing Illinois base income.

The Department has issued rulings requiring the add-back of interest on state and local obligations that are exempt from federal income taxation under §103 of the Code and interest on loans made to employee stock ownership plans under former §133 of the Code. However, there do not appear to be any Illinios rulings or other guidance on the treatment of portfolio interest income which is exempt from federal income tax under §881(c) of the Code.

We believe that the Illinois Legislature did not intend that portfolio interest income be added back to a corporation's federal taxable income in computing Illinois base income. As a policy matter, it would seem illogical for Illinois to subject to taxation a particular category of income of a foreign corporation which is specifically exempt from income taxation by the federal government. Congress enacted the portfolio interest income exemption to stimulate investment by foreign persons in the United States. State taxation of portfolio interest income would be inconsistent with the intent of the federal government.

ISSUE 2.

Even if the Department rules that portfolio interest income is required to be added back to federal taxable income in computing Illinois base income, portfolio interest income will only be subject to Illinois income taxation if such income is subject to apportionment to Illinois. Most corporations are subject to the three-factor apportionment formula, although the IITA provides special apportionment formulas for financial organizations and certain other industries. Consequently, it is necessary to determine whether the Foreign Corporation would be characterized as a "financial organization" subject to a special one-factor apportionment formula or otherwise subject to the three-factor apportionment formula. Section 1501(a)(8) of the IITA defines a "financial organization" to include "any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company." It is not clear under existing law whether the Foreign Corporation would be classified as an "investment company" and, consequently, fall within the definition of a financial organization.

However, the Department recently issued proposed regulations that would clarify what specific types of entities are classified as "investment companies." Under Proposed 86 Illinois Administrative Code §100.9710(d)(11), the term "investment company" means an entity which comes within the meaning of 15 U.S.C. §80a-3(a) or 815 ILCS 5/7, and is predominantly engaged in the business of investing, reinvesting and trading in securities. 15 U.S.C. §80a-3(a) defines an investment company as an entity engaged in the business of investing, reinvesting and trading in securities. Section 100.9710(d)(11)(A) states that the characteristic services of an investment company are the raising of capital from investors in order to purchase capital securities or other entities and gross income from such services includes interest, dividends and gains from sales of securities. Additionally, §100.9710(d)(11)(B) provides that in order to be

characterized as an investment company under the IITA, an entity doing business in Illinois must register its shares under 815 ILCS 5/7 and an entity doing business in the United States must be registered as an investment company with the Securities and Exchange Commission. Any other entity must be subject to the equivalent authority (if any) in its state or country of formation or commercial domicile.

Under the proposed regulations, if the Foreign Corporation complied with the registration requirements of §100.9710(d)(11), the Foreign Corporation would be classified as a financial organization for Illinois income tax purposes. Alternatively, it appears that the Foreign Corporation could choose not to comply with the registration requirements and, consequently, not be classified as a financial organization.

ISSUE 3.

Under §304(c) of the IITA, business income of a financial organization is apportioned to Illinois by multiplying such income by a fraction, the numeration of which is its business income from sources within Illinois, and the denominator of which is its business income from all sources. Business income of a financial organization from sources within Illinois is the sum of the following: (i) fees, commissions or other compensation for financial services rendered within Illinois; (ii) gross profits from trading in stocks, bonds or other securities managed with Illinois; (iii) dividends, and interest from Illinois customers, which are received within Illinois; (iv) interest charged to customers at places of business maintained within Illinois for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and (v) any other gross income resulting from the operation as a financial organization within Illinois.

It is not clear whether the Agreement between the Foreign Corporation and the Independent Contractor for the performance by the Independent Contractor of the services described above would cause any base income of the Foreign Corporation to be apportioned to Illinois. Although §304(c)(1) includes in Illinois source income “[g]ross profits from trading in stocks, bonds or other securities managed within this State,” we do not believe that management in Illinois solely through an independent contractor relationship should be taken into account. As discussed below, for purposes of the three-factor apportionment formula in Illinois, it appears that independent contractor relationships are not taken into account in apportioning income to Illinois. Accordingly, because the arrangement between the Foreign Corporation and the Independent Contractor created by the Agreement is an independent contractor relationship, the Agreement should not be taken into account in apportioning income to Illinois. It would seem inconsistent that a corporation that is not engaged in a United States trade or business for federal income tax purposes would nevertheless have business income that is apportioned to Illinois.

ISSUE 4.

For taxable years ending on or before December 30, 1998, under the three-factor apportionment method, a corporation's business income is apportioned to Illinois by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and the double-weighted sales factor (if any) and the denominator of which is four (4) reduced by the number of factors other than the sales factor which have a denominator of zero (0) and by an additional two (2) if the sales factor has a denominator of zero (0). For taxable years ending on or after December 31, 1998 and before December 31, 1999, the apportionment factor is equal to 16 2/3 percent of the property factor, plus 16 2/3 percent of the payroll factor, plus 66 2/3 percent of the sales factor. For taxable years ending on or after December 31, 1999 and before December 31, 2000, the apportionment factor is equal to 8 1/3 percent of the property factor, plus 8 1/3 percent of the payroll factor, plus 83 1/3 percent of the sales factor. For taxable years ending on or after December 31, 2000, the apportionment factor is equal to the sales factor.

Sales Factor. The sales factor is a fraction, the numerator of which is the total sales of the corporation in Illinois during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. The sales factor includes gross receipts from intangible personal property. Sales of intangible personal property are in Illinois if (i) the income-producing activity is performed in Illinois or (ii) the income-producing activity is performed both within and without Illinois and a great proportion of the income producing activity is performed within Illinois than without Illinois, based on performance costs. 86 Illinois Administrative Code §100.3370(c)(3)(A) provides that the term "income-producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the corporation in the regular course of its trade or business for the purpose of obtaining gains or profit. Section 100.3370(c)(3)(A) specifically states that "[s]uch activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor." Consequently, the activities of the Independent Contractor pursuant to the Agreemnt would not be considered "income-producing activities" and would not be taken into account in determining the sales factor.

Payroll Factor. The payroll factor is a fraction, the numerator of which is the total amount paid in Illinois during the taxable year by the corporation for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year. Section 1501(a)(3) of the IITA defines the term "compensation" as "wages, salaries, commissions and any other form of remuneration paid to employees for personal services." 86 Illinois Administrative Code §100.3100(b) defines the term "employee" to include "every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee." Additionally, under §100.3100(b), if the employer-employee relationship does not exist, remuneration for services performed does not constitute "compensation."

As indicated above, the payroll factor does not include fees paid to independent contractors. Accordingly, fees paid by the Foreign Corporation

to the Independent Contractor pursuant to the Agreement would not be taken into account in determining the payroll factor.

Property Factor. The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in the trade or business in Illinois during the taxable year, and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used in the trade or business during the taxable year. There does not appear to be any guidance regarding the treatment of property owned or rented by independent contractors for purposes of determining the property factor. However, since independent contractor relationships are not taken into account under either the sales or payroll factors, it logically follows that such relationships are not intended to be taken into account under the property factor.

CONCLUSIONS

Based on the foregoing analysis, we request that the Department rule as follows:

1. Portfolio interest income which is exempt from federal income tax under §881(c) of the Code is also exempt from Illinois income tax and is not an addition modification to federal taxable income under §203(b)(2)(A) of the IITA;

2. If the Foreign Corporation complies with the registration requirements of Proposed 86 Illinois Administrative Code §100.9710(d)(11), the Foreign Corporation would be classified as a "financial organization" within the meaning of §1501(a)(8) of the IITA;

3. The execution of the Agreement between the Foreign Corporation and the Independent Contractor for the performance by the Independent Contractor of the services described above will not cause income of the Foreign Corporation to be apportioned to Illinois under the one-factor apportionment formula applicable to financial organizations; and

4. The execution of the Agreement between the Foreign Corporation and the Independent Contractor for the performance by the Independent Contractor of the services described above will not cause income of the Foreign Corporation to be apportioned to Illinois under the three-factor apportionment formula applicable to corporations.

DISCUSSION

Issue 1: You correctly note that Illinois follows the federal guidelines for the classification of business entities. Accordingly, a corporation for federal

income tax purposes would be a corporation for Illinois income tax purposes. Furthermore, the Illinois Income Tax Act ("IITA") computes the Illinois income tax for such entities by taking their taxable income for federal purposes and then subjecting this figure to several addition and subtraction modifications found at §203(b) of the IITA. Section 203(b)(2)(A) adds back to the income figure all amounts paid to the taxpayer as interest and all distributions received from regulated investment companies to the extent excluded from income from the foreign corporation's federal taxable income.

Portfolio interest earned by a foreign person is not excluded from gross income under §881(c) of the Internal Revenue Code ("IRC"). Instead, that section provides such income is not subject to the special tax imposed under §881(a) of the IRC. Accordingly, you are correct to therefore exclude portfolio interest income, as determined under §881(c) of the IRC, from the base income calculation for Illinois income tax purposes.

Issue 2: The Department is unable to determine whether the taxpayer is a financial organization under §1501(a)(8) of the IITA as not enough facts concerning the business operations of the company were included within the letter. As you point out, however, the key factor is whether the taxpayer is an "investment company" and hence a financial organization. The Circuit Court of Cook County recently interpreted the meaning of "investment company" in Shaklee Corp. v Department of Revenue, 93 L 50530 (Cir. Court Cook Co., 1996). The court stated:

> In the court's view, the term "investment company" must be defined, as suggested by the Department, so as to result in a construction which is harmonious with these other entities. To that end, the court interprets the legislature's grouping of investment companies with these entities which are engaged in banking and lending businesses to reflect its intention to exclude from unitary business groups only investment companies actively involved in such businesses. In other words, to qualify as an investment company, an entity must do more than hold a given percentage of its assets in securities. Rather, it must be engaged in the investment business with its underlying purpose being a return on its investments. In fact, the definition of "investment company" which appears in the 6th Edition of Black's draws this precise distinction between an investment company and a holding company: "An in vestment company differs from a holding company in that the latter seeks control of the ventures in which it invests while an investment company seeks the investment for its own sake and normally diversifies its investments." Black's Law Dictionary, 826 (6th Ed. 1990). Furthermore, the legislative grouping of these entities was not done haphazardly, but rather was done with a recognition that fundamental differences exist between manufacturing businesses and those involved in public banking and investing. As explained in the decision of the Administrative Law Judge, the drafters of the Uniform Division of Income for Tax Purposes Act (UDITPA) intended to exclude certain business activity from the operation of the general three factor rules, including financial organizations which "are different from manufacturing and mercantile business activities" and which "are governed by special state and federal regulations for entities engaged in lending or investing for the public." R. 1239.)

Shaklee, 93 L 50530.

The critical factors under this decision are therefore the structure of the company and its subjection to federal and state regulation. The proposed regulation you mention on page five of your letter was never promulgated and therefore may not be cited as authority. Without the additional information the Department can only give you a general explanation of the law.

Issue 3: The question as to whether the taxpayer, if it were deemed a financial organization under the IITA, would have to apportion income to Illinois is not one that can be answered in the context of a General Information Letter. As you mention in your letter, §304(c) does contain language which could require allocation of income to Illinois. However, without access to more information about the terms of the independent contractor relationship and the activities of the taxpayer I cannot tell if there are sufficient contacts to require such an allocation. The mere fact that the relationship exists through an independent contractor does not negate the possibility that an income allocation would have to be made.

One further point to consider is that there may be nexus between the taxpayer and Illinois yet no income would be allocable to the state. That is, the taxpayer may have nexus with Illinois, and thus have to file an Illinois income tax return, but not have any income apportionable to the state. Whether such nexus exists cannot be determined except in the context of an audit wherein the auditor would have full access to all of the facts and circumstances

Issue 4: Income allocation using the three-factor analysis explained in §304(a) requires a cost of performance test involving analysis of the taxpayers contacts with Illinois. You correctly point out in your letter that 86 Illinois Administrative Code §100.3370(c)(3)(A) states that independent contractor relationships does not qualify as "income producing activity." Similarly, 100.3360(a)(3) and (a)(4) specifically state that the definitions of "compensation" and "employee" as found in §100.3100 control for purposes of the payroll test in §304(a) of the ITTA. Using these definitions an independent contractor relationship, by itself, would not require allocation of income to Illinois. Neither would there likely be a property factor since the taxpayer must own or rent property to qualify under the statute and pertinent regulations. You appear to have access to all of the information I have mentioned so I will not send you copies of the listed regulations; however, they are available if you so wish.

Accordingly, from the information presented as to the type of contacts the taxpayer would be having with Illinois (i.e. strictly an independent contractor relationship) it appears that there may be no income allocable to the state. Once again, I should mention that it might still be possible that there would be nexus with Illinois but no income apportionable to the state.

I hope this has been helpful, If you need any further assistance please feel free to write to me at the above address.

Very Truly Yours,

Charles Matoesian
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